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T H E S I S

TAXATION OF SMALL BUSINESS

by

Harold Hurst
(A.B. Harvard College 1938)

submitted in partial fulfillment of
the requirements for the degree of

MASTER OF BUSINESS ADMINISTRATION

1947

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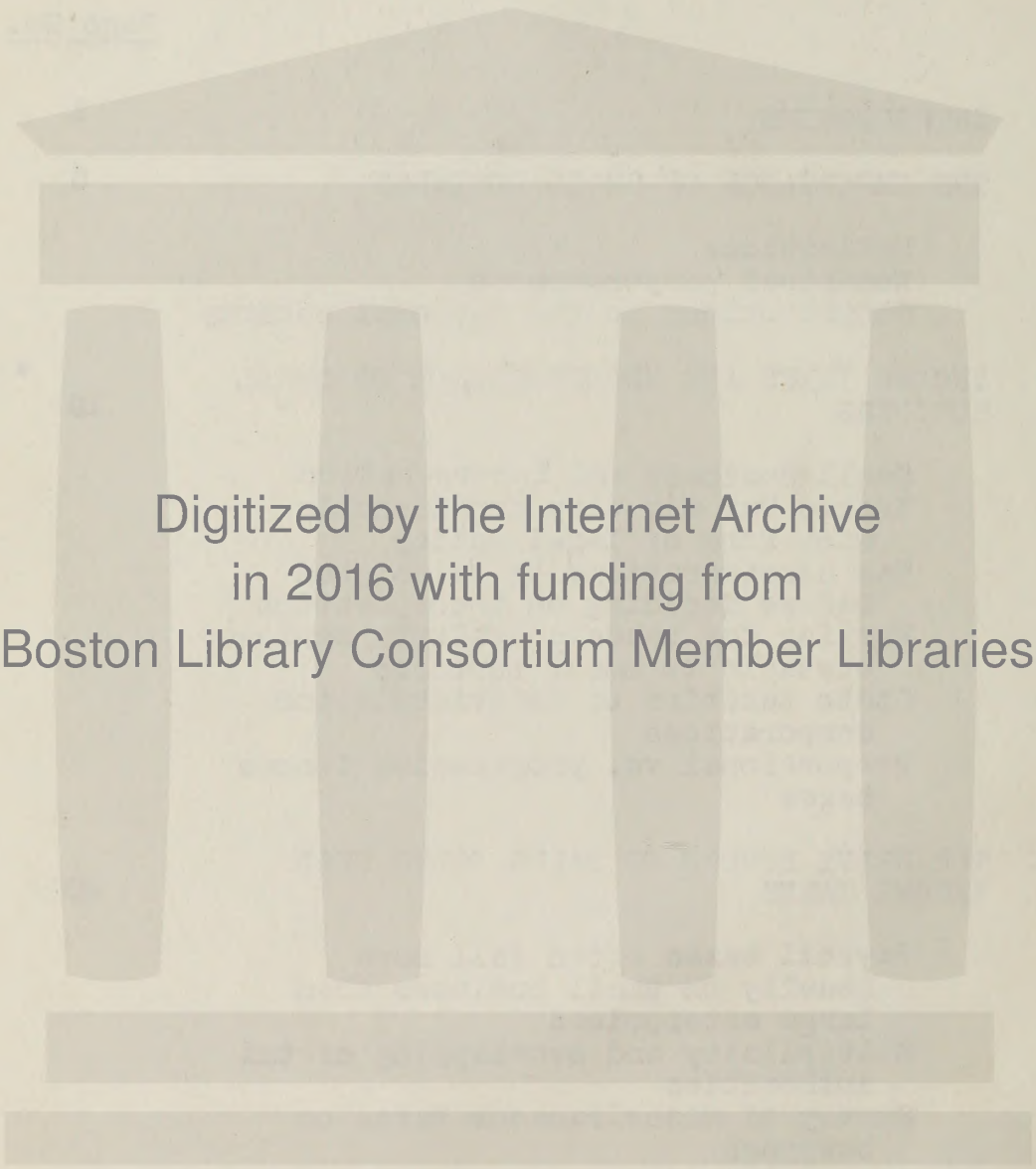

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INTRODUCTION

The growing concentration of economic power has given many of our greatest leaders grave cause for concern since the days of Thomas Jefferson. Huge corporations have arisen which possess vast resources, power and wealth far beyond the total assets of the States which gave them birth.

Small business has been crowded entirely out of some industries and has been reduced to a very minor role in others, but there are still millions of individual entrepreneurs who contribute in great measure to the national economy. These businessmen constitute a strong and vital force for maintenance of our system of free private enterprise.

The problems of small business in the field of taxation are of primary concern in this paper; but the fact must be emphasized that other problems perhaps even more serious beset this segment of our economy. Most urgent among these problems are difficulties in obtaining equity capital and long-term loans, destructive competition, extreme susceptibility to cyclical influences, and instability of income. The resulting high mortality rate is a

subject of discussion in a later chapter. The plight of small business may well be summarized in the observation that in 1938 less than half of all unincorporated enterprises reported any taxable income.[1]

The objectives of this paper are several:

1. To attempt to define "small business" and picture its place and importance in the national economy.

2. To deal at length with taxation differences arising from use of the corporation as a legal form of enterprise, with special reference to differences in taxation of income.

3. To bring out the fact that in a government largely subject to pressure politics, small businessmen, unorganized and ineffective, have little voice, and consequently many are the tears that are shed for them, but little is done.

4. To elaborate on the staggering burden of taxes other than income taxes which fall on the entrepreneur.

5. To suggest possible changes in taxation policies to aid small business.

6. To emphasize the effect on management policy of present tax laws. Expert accounting and legal advice must be retained to comprehend our complex tax codes -

1. Dun and Bradstreet
"A Survey of Taxes Paid by Business in 1938", p.11

talent which few small businessmen can afford to hire.

At this writing, two Congressional committees are investigating the problems of small business. On April 29, 1938, in his message to Congress, President Franklin D. Roosevelt publicly recognized the growing tendency toward a dangerous concentration of economic power in a relatively few large corporations. Soon thereafter, the investigations of the Temporary National Economic Committee on this subject were conducted at a cost of over a million dollars. This study is one of the most voluminous of its kind ever attempted and consumed over 17,000 pages of testimony.

Not only has the government become increasingly interested in small business, but many economists have stressed the thesis that the back-bone of this country is its middle-class, and that the flexibility and strength of our system of free enterprise is dependent upon the preservation of the millions of independent entrepreneurs. Strangely enough, however, in comparison to a voluminous amount of literature on the subject of "big business", there are relatively few works on the results of research in the field of small business.

Statistics on so-called "one-man businesses" are not easily available. Thousands of these firms keep

a minimum of records; many never even submit tax returns, apparently, and keep no books at all. Consequently, researchers are handicapped by the lack of classified data. Accurate conclusions are difficult to draw and substantiate.

The large corporation and the small firm has each its place in the economic system. Both contribute to raising our standard of living and strengthening our industrial position. However, the preservation of a well-balanced economy has become a serious problem. Encouragement of independent private enterprise as an integral part of this economy must be sponsored, especially because it is unorganized and, therefore, at a great disadvantage in a government largely influenced by pressure politics.

Small business does not need a subsidy, but, because its position is so precarious, it cannot be taxed on the same basis as powerful industrial empires. It needs certain tax privileges to survive and grow (with special reference to new businesses); given these rights, it will take care of itself. The power to tax is a potent one, especially in its effect on business prosperity. It has been truly said that "some portion of practically every known kind of tax, except inheritance and gift taxes, is collected from or through business concerns or from the earnings of business enterprise."[1] Liberal

1. Dun & Bradstreet, "A Survey of Taxes Paid by Business in 1938", p. 5

tax treatment for small business does not mean a penalty would be imposed upon size, nor that the advantages of large size would be nullified; it means free private enterprise would become more of a reality than a mere phrase.

I THE IMPORTANCE OF SMALL BUSINESS

In every phase of industrial and commercial activity - manufacturing, wholesaling, retailing and service - the overwhelming majority of establishments may be considered small. There is no clear-cut, authoritative, single standard of size by which a business may be judged; but for purposes of this paper, the following definitions are considered representative.

Some definitions of small business are indirect. Dr. W. H. Gilbert uses the classification"opponents of big business, competitors to chains, independent retailers, single stores, local interests and banks not of the branch or chain bank type".[1]

The Department of Commerce considers retail stores and service establishments with annual net sales or receipts of less than $50,000, small. In 1939, there were 1,600,000 retailers in that class out of a total of 1,770,000, and there were 638,000 service establishments in that class out of a total of 646,000. The Department considers a wholesaler small if he has annual net sales of less than $200,000. A manufacturer is deemed to be small if his employees number one hundred or less. [2] About ninety-two per cent of all manufacturers are in this group.

1. "Small Business Problems" - p. 1
2. "Small Business - A National Asset" p.2

If, as a matter of convenience, small business should be classified as being composed of firms having assets less than $250,000, less than one per cent of the business population would fall into the category of "big business".[1]

The common yardstick of comparison might best be net worth, but unfortunately, authoritative comparable statistics are not available. It must be conceded that a definite arbitrary line of demarcation can hardly be drawn between the two classifications of size. It is necessary only to appreciate the fact that even by Department of Commerce standards, there are millions of entrepreneurs whose problems are closely linked to those of small business in general. The important distinction is that the segment of the economy under discussion includes, under any reasonable definition, approximately nine out of every ten business establishments in the nation.[2] Using a broad definition of this type, the labor of these nine out of ten firms accounts for one-third of the total dollar value of all goods produced and services rendered by the American economy.

Perhaps the best method of bringing out the tremendous weight in numbers of small business is by use

1. Temporary National Economic Committee Monograph No. 17, p. 247 "Problems of Small Business"
2. Department of Commerce, "Small Business - A National Asset" Forward by O. P. Hopkins

of Department of Commerce tables and charts drawn from the 1939 Census.

MANUFACTURING

TABLE I

SUMMARY OF PERCENTAGE OF TOTAL WAGE EARNERS CLASSIFIED BY SIZE OF ESTABLISHMENTS [1]

Size Class (No. of Employees)	Percent of Total Wage Earners	
1 - 5	2.6	Note:- Thirty per cent of all wage earners in mfg. industry are employed in factories using less than 100 wage earners.
6 - 20	6.9	
21 - 50	9.7	
51 - 100	10.8	
101 - 250	18.7	
251 - 500	16.1	
501 - 1000	13.0	
1001 - 2500	11.9	
2501 or more	10.5	
T o t a l	100.0	

Out of a total of 184,230 manufacturing establishments, 168,814 employed one hundred people or less. [2]

1. U. S. Department of Commerce, Bureau of the Census Volume IV, p. 119

2. U. S. Department of Commerce, Bureau of the Census Volume IV, p. 120

TABLE II

SUMMARY FOR ESTABLISHMENTS CLASSIFIED AS TO SIZE BY VALUE OF PRODUCTS: 1939 [1]

Size Class by Value of Products	No. of Establishments		Value of Products
$ 5,000 to $ 19,999	60,593	*	$ 680,777,195
20,000 to 49,999	42,083	*	1,353,675,907
50,000 to 99,999	25,490	*	1,811,463,114
100,000 to 249,999	24,718	*	3,920,974,218
250,000 and over	21,346		49,076,134,360
All establishments	184,230		$56,843,024,794

(*) "small business"

It is interesting to note that only eleven per cent of the total number of establishments manufactures eighty-seven per cent of the total value of the products. Though small business here, too, constitutes an overwhelming numerical majority, it is not apparently a really significant factor. There is little question but that manufacturing is largely the exclusive province of big business.

WHOLESALE

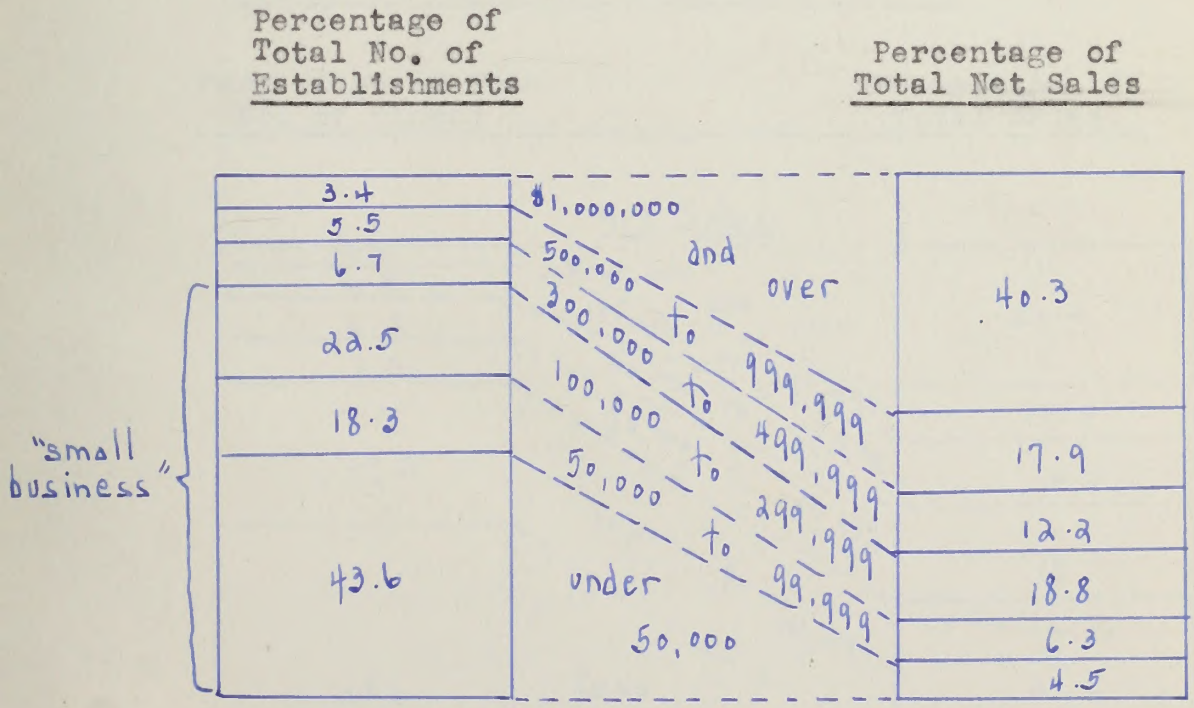
In wholesale trade, small business again is numerically well represented, but only a small

1. U.S.Department of Commerce, Bureau of the Census Volume IV, p. 182

percentage of the total business falls to the "little fellow".

The following chart brings out the fact that eighty-four and four-tenths per cent of the total number of establishments in the census had net sales of less than $300,000 per year, and that such sales comprised but twenty-nine and six-tenths per cent of the total wholesale net sales.[1]

CHART I



1. U. S. Department of Commerce, Bureau of the Census Volume II, p. 18

Wholesaling is not ordinarily considered as restricted to "big business", yet it is evident that forty and three-tenths per cent of the total net sales was made by an extremely small number of firms.

RETAIL

In retail trade, we see a relationship between sales and size groups strikingly similar to that in wholesale trade.

CHART II

STORES AND SALES BY SALES-SIZE GROUPS [1]

Percentage of Total No. of Stores	Net Sales	Percentage of Total Sales
0.7	$300,000 and over	23.4
2.8	100,000 to 299,999	18.9
5.3	50,000 to 99,999	15.2
7.5	30,000 to 49,999	12.1
29.5	10,000 to 29,999	21.3
54.2	Less than $10,000	9.1
Total: 1,770,355		$42,041,790,000

1. U. S. Department of Commerce, Bureau of the Census Volume I, p. 47

It is clear that more than fifty-four per cent of all retail stores in the United States did less than $10,000 worth of business in 1939 - small business indeed! Independent stores, as a matter of fact, constituted ninety-three per cent of all stores in 1939, and their sales amounted to seventy-seven and two-tenths per cent of total sales in 1939.[1]

Among service establishments such as hotels, tourist courts, etc., the preponderance in numbers of individual proprietorships and partnerships, indicating generally small establishments, is very marked. Out of a total of 646,028 establishments, 617,567 were non-corporate enterprises.[2]

The problems of determination of legal entity - the advantages and disadvantages from a tax viewpoint of incorporation-will be discussed at length in a later chapter. However, it would be appropriate at this point to stress the great number of small business undertakings which exist without benefit of incorporation.

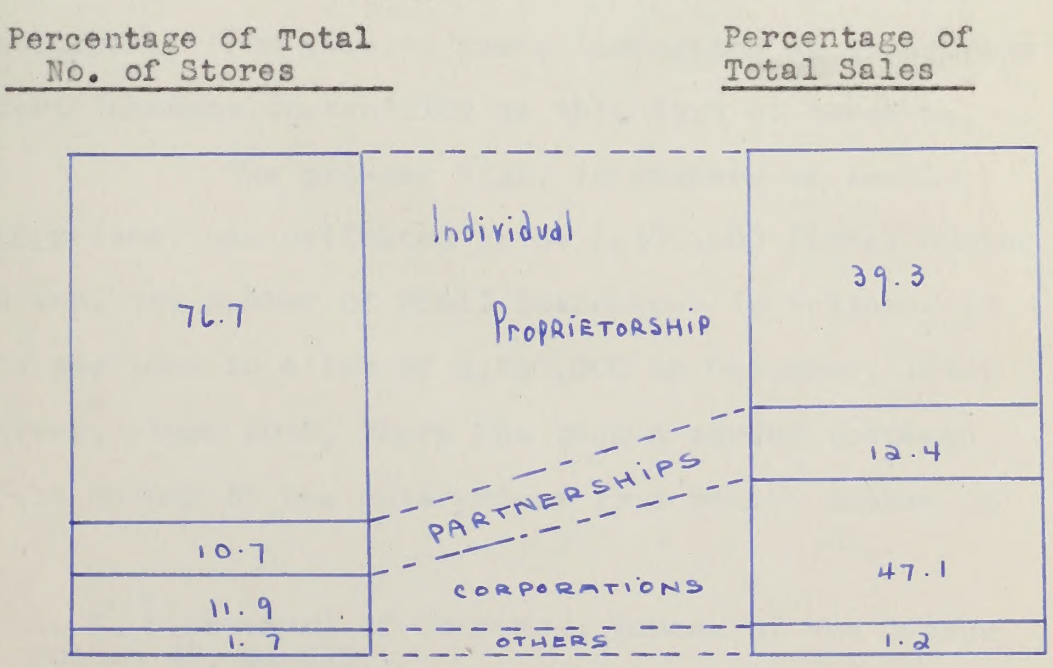
In wholesale trade in 1939, out of a total of 200,573 establishments, 98,646 were either individual

1. U. S. Department of Commerce, Bureau of the Census, Volume I, p. 49
2. U. S. Department of Commerce, Bureau of the Census, Volume III, p. 96

proprietorships or partnerships.[1] However, though numerically almost fifty per cent in strength, this group did only 22.0 per cent of the net sales and paid only fifteen per cent of the total payroll.[2]

In the retail store business, more than 76 per cent of the 1,770,355 stores in operation in 1939 were sole proprietorships owned by individual entrepreneurs, and these stores accounted for 39.3 per cent of all retail sales, an average of $12,174 per store. Partnerships of two or more individuals operated 189,631 stores or 10.7 per cent of all stores. Corporations, though less than 12 per cent in number of all retail stores, accounted for 47.1 per cent of total retail sales.[3]

CHART III



1. U. S. Department of Commerce, Bureau of the Census Volume II, p. 26
2. U. S. Department of Commerce, Bureau of the Census Volume II, p. 26
3. U. S. Department of Commerce, Bureau of the Census Volume I, pp 35 and 36

Although in 1939, there were only approximately 6,000 more incorporated manufacturing establishments than unincorporated ones, those incorporated did over twelve times as much business.[1]

The conclusion to be drawn from the foregoing statistics is that in every field except service, large enterprises dominate in value of products or total sales, but there are large numbers of small entrepreneurs contributing in great measure to the national economy and to preserving the American tradition of free enterprise. In 1942, proprietorships and partnerships alone (practically all of which come under the small business classification) made profits of $12,818,994,000, a considerable portion of the national income.[2]

The total number of small businesses fluctuates considerably from year to year, indicating an apparently almost inherent instability in this type of concern.

The pre-war high, in numbers of small enterprises, was estimated to be 3,400,000 firms; during the war, the number of small businesses is believed to have declined to a low of 2,830,000 in December, 1943; however, since 1945, there has been a marked increase in the number of new enterprises to a record number in

1. U. S. Department of Commerce, Bureau of the Census Volume IV, p. 229
2. U. S. Bureau of Internal Revenue, "Statistics of Income for 1942", p. 18

January, 1947, a healthy stimulus to our system of free and fair private enterprise. The National Industrial Conference Board released to the press on January 8, 1947 in New York, a prediction that "the number of (small) firms may exceed the pre-war high by as many as from 300,000 to 500,000 concerns . . . . . This will reverse the war time trend."[1] The surrender of Germany and Japan was followed by the greatest expansion in our history in the number of new firms.

1. Boston Evening Traveler, January 8, 1947

II INCOME TAXES AND INCORPORATION OF SMALL BUSINESS

A decision to incorporate a small business may have important tax consequences and must be considered carefully. It is often debatable whether the advantages of a corporate charter are worth the cost in Federal and State taxes. It may be doubted whether Congress deliberately intended to discourage the use of incorporation to small business, yet at times, this has been the indirect result of tax legislation.

When an entrepreneur decides to incorporate, he immediately subjects himself to the same tax law as giant industrial companies. It does not seem reasonable that the corner drug store should be caught in legislation designed for application to multi-million dollar concerns.

Incorporation is typical of the manufacturing field, but partnerships or proprietorships are much more common in retail business. Numerically, the corporation is becoming more characteristic. Whereas the number of firms, including corporations, increased only 45 per cent between 1910 and 1930, the number of corporations increased by 90 per cent.[1]

Those industries requiring considerable capital are largely incorporated. Small business has been relegated to trade, service, and, perhaps, construction industries

1. "The Concentration of Economic Power", by David Lynch, p. 93

where entrance into business is comparatively easy and proprietorship or partnership is the rule.

TABLE III
IMPORTANCE OF CORPORATE ACTIVITIES [1]

(In Designated Industries, 1937)

Industry	Percentage of Business Done by Corporations In Each Industry
Electric Light & Power & Manufactured Gas	100
Communications	100
Mining	96
Manufacturing	92
Transportation	89
Finance	84
Government	58
*Trade	58
Contract Construction	36
*Service	30
Miscellaneous	33
Agriculture	7

(*) Industries in which small business is most important

Incorporation for general business purposes (on the theory that grant of a public charter would be

1. "The Concentration of Economic Power", by David Lynch, p. 94

for the public good) first was authorized in 1811 in New York and became lawful in all existing States in 1875, though many states had restrictions both on the length of life of the corporation and the amount of its authorized capital. Forty-eight states, the District of Columbia and the Federal government can now grant corporate charters. Each of these jurisdictions has its own court interpretations, a situation which has given rise to a very complex corporation law.

State restrictions are now of not too great consequence. The liberality of one state causes the effect of restrictions by any others to be largely nullified as businesses flock to the most liberal state. Incorporation is had for the asking rather than being granted on proof of public services to be rendered as originally intended.

The simple myth that in the eyes of the law a corporation possesses individuality has resulted in far-reaching consequences. Attacks on corporation evils are met with thedefense that the liberty and constitutional rights of an individual are being threatened. The fantastic notion has arisen that the corporation has the right of any citizen of the state which gave it citizenship, though actually the said corporation may not even do business in the state of its incorporation. In the place of an individual economy, this is an age of corporacy characterized by great

masses of property intricately organized around a legal fiction - the corporation.

Special taxation of corporate entities has long been justified in the eyes of the law under several bases:

1. There is a fee owing to the state because the state bestows a privilege on the parties forming the corporation. Those states having the most favorable laws have the lowest fees. The "privilege" fee for a corporation having 1,000,000 shares of no-par common stock would be only $2550 in Delaware, compared to $50,000 in New York.

2. The corporate creature of another state cannot enter free of charge, thus justifying taxation of "foreign" corporations. Both filing fees (Mass. - $50) and annual franchise taxes are collected. Discriminatory taxation has often been attempted to protect home-state business. No such problems exist for partnerships.

3. The state is due an annual fee for conducting business as a corporation. These annual tax rate variations are very high between states. If the same corporation as in (1) earned $8,000,000, the tax, if incorporated in New York would be $480,000; in Delaware, it would be $2500.

4. Corporation income, like other income, is subject to tax by both state and Federal governments. These state income taxes are imposed by more than 30 states and are not generally more than 5 per cent.[1]

5. When extra revenue is needed by the government, corporation "excess profits" and undistributed profits are fertile sources; also, it is easier to tax 529,000 corporations than millions of individual entrepreneurs.

6. Corporations as a group obtain the vast bulk of the gross receipts and net profits accruing to business enterprise, and therefore, from an economic point of view, special taxation is necessary. The Federal corporation income tax is a very important single source of revenue to the government.

1. "Postwar Tax Policy and Business Expansion", Lewis Kimmel, p. 25

7. The government gave the corporation birthright and, therefore, has a logical right to regulate it.

The small business man is sometimes confronted with the problem of selecting a state for incorporation. If his operations are intra-state in character, in practically all instances it is cheapest to get a domestic charter rather than be classed as a foreign corporation, because, unlike a natural person, a corporation has no right to do business in a "foreign" state unless permission is granted and paid for. Where operations are interstate, the problem becomes one of incorporating in the state conferring the broadest powers at the lowest tax rates - a combination which certain states like Delaware specialize in. Incorporation was not intended to be a right, but a public trust, but actually it is closer today to a right than a trust.

The conduct of "interstate business" by a foreign corporation may be accomplished free of state interference and taxes, but declaring business to be interstate may mean loss of the privilege of enforcing contracts in state courts.

Mere maintenance of a sales office in a state may mean that the corporation can be taxed like a domestic corporation even though all business solicited is interstate.[1]

The question of size is of no concern insofar as minimum capital required goes; there have been cases of

1. "What's Happening in Taxation and Government Regulation", Prentice-Hall Vol. 9, No. 21, November 4, 1946

companies with capital stock of $5,000 having liabilities of $1,000,000. Residence and legal requirements are generally so lenient as to be no obstacle at all.

The question is often asked, "Which is best for my business, incorporation or proprietorship?" There is no formula or absolute answer, but each case must be determined individually. A relatively heavier tax burden upon incorporated enterprise as compared to unincorporated may easily be the marginal factor which determines whether a business should incorporate.

What is most advantageous taxwise must depend on estimates of future income, the necessity for distribution of that income, forecasts of Congressional attitudes, prognostication of judical trends, and estimates of postwar economic conditions.

TABLE IV

SUMMARY OF THE RELATIVE ADVANTAGES OF PARTNERSHIP OR CORPORATION FOR SMALL BUSINESS

PARTNERSHIP	CORPORATION
Lower tax rates for low net incomes	Lower tax rates for net incomes over about $13,000
No penalty for retaining earnings in business	Limited liability
Reduced state taxes	Continuous existence
Possibility of dividing income through "family partnerships"	Ease of making gifts and of transferring interests
Business losses are deductions from personal income	Ease of splitting the business into several completely separate units

SUMMARY OF THE RELATIVE ADVANTAGES OF PARTNERSHIP OR CORPORATION FOR SMALL BUSINESS (CONT'D)

PARTNERSHIP	CORPORATION
Tax-exempt income does not lose its characteristics	Stockholder-employees may be included in pension or profit-sharing plans
Partner's salary not subject to payroll taxes	
May be able to bring business below 8 employees, saving Federal unemployment payroll taxes	
Ease and lack of formality in starting business - no qualification and organization fees.	
Freedom in doing business in other states	
Profits distributable in any ratio	
No worries about exceeding the authority granted by the state	
More favorable capital gains and losses provisions	
No certificate of condition or other information returns to file periodically	
No publication of balance sheet by the state	
15 per cent of adjusted gross income allowed as deduction for contributions	
Lower state income tax rates - simpler returns (Mass.)	
No stock transfer taxes	

The traditional advantage of incorporation to small enterprises is limited liability. In a partnership, any partner can bind the other partners, and, of course, all are fully liable. Directors, however, are rarely liable for anything but fraud or extreme negligence. The liability of stockholders is limited to unpaid stock subscriptions, liability for watered stock sold on the representation that it is fully paid, and liability to return unlawful dividends or capital withdrawals. In many states, stockholders are also liable for wages owed to employees by the corporation. In New York, under this statute, any stockholder may be sued by an employee for the entire amount owing to him, but such stockholder would have the right to demand reimbursement pro rata from his fellow stockholders. In Pennsylvania, shareholders are liable for wages only equal to the value of the shares owned by them.[1]

The entire concept of limited liability is often overstressed. Insurance can take care of most types of liability. As a practical matter, a small business man is frequently requested by his creditors to personally endorse or guarantee his company's indebtedness. In fact, incorporation of an old enterprise may cause creditors to become extremely wary of advancing new credit. Also, stockholders, in cases of fraud, have been held liable by the courts.

Under present bankruptcy laws, the old conception of debtors going to prison for non-payment of bills is no longer effectively applicable to business debtors. Therefore, it is debatable whether incorporation for small business

1. "Corporation Law for Officers and Directors", by William J. Grange, The Ronald Press Company, New York, 1940, p. 312

simply to escape full liability is as valuable a privilege as it appears.

In general, a small corporation will find it as difficult to get new capital as a small partnership. There are no security markets set up for issued of small enterprises.

The"deathless" character of the business is of considerable advantage. It is especially important in medium and large size businesses, but in millions of very small enterprises entirely dependent on the experience, contacts and sagacity of the owner, it is doubtful if the business could be continued on a profitable basis in any case.

The most important single consideration is normally the comparative Federal normal and surtax rates on corporations and individuals. As of the present date, total normal tax and surtax for individuals ranges from 19 per cent of surtax net income to not more than 85.5 per cent of surtax net income. Total normal and surtaxes for corporations range from 21 per cent to a maximum of 38 per cent. It would seem extremely advantageous <u>from this point of view</u> for a business man with a surtax and normal tax net income of over about $13,000 from his business profits to have his business incorporated, if his profits are to be retained in the business. The table on the following page will help explain the difference in rates.

TABLE V

COMPARATIVE EFFECTIVE RATES OF FEDERAL INCOME TAX

INDIVIDUAL (Percent)	TOTAL NORMAL AND SURTAX	CORPORATION (Percent)
19.0	0 - 2,000	
20.9	2,001 - 4,000	21
24.7	4,001 - 5,000	
24.7	5,001 - 6,000	
28.5	6,001 - 8,000	
32.3	8,001 - 10,000	
36.1	10,001 - 12,000	
40.85	12,001 - 14,000	
44.65	14,001 - 16,000	21 - 23
47.5	16,001 - 18,000	
50.35	18,001 - 20,000	
53.2	20,001 - 22,000	
56.05	22,001 - 25,000	23 - 25
56.05	25,001 - 26,000	
58.9 - 68.4	26,001 - 50,000	25 - 38 (maximum)
71.25 - 85.5	Over 50,000	

Since 1913, there has been ostensible parity between the Federal corporation income tax and the personal income tax only in one year - 1918. In that year, the excess of the individual taxable income over $4000 was set at 12 per cent and the corporation income tax was also 12 per cent. In 1919, the parity ended and has not since been restored.

Under the corporation and personal income tax rates in force in 1922 and 1923, individuals whose incomes were under $22,000 were subject to a heavier tax on their

corporate earnings than on their income from other sources. The downward revision of personal income tax rates for 1924 raised the dividing line to $26,000. The dividing line was raised in 1925 to $32,000 and to $36,000 in 1926. The Revenue Act of 1928 reduced the rate of the corporation tax for the first time, and this rate change lowered the dividing line to $28,000.[1] Since 1928, the line of parity has fluctuated more violently and was influenced greatly by undistributed profits taxes and excess profits taxes. In 1946, the dividing line of $13,000 makes it particularly attractive for organizations with higher net incomes to incorporate. The significant point is that the frequent variations in the parity line make it extremely difficult for small businesses to make a long range decision which will result in the lowest income taxes. Large enterprises are not faced with this problem because net earnings are normally far above the parity line anyway, and the corporation is the only feasible method of organization for capital reasons.

The recent repeal of excess profit tax provisions has induced a stampede toward incorporation, a reversal of the wartime trend toward dissolution of corporate status. Changes in surtax and normal tax rates, either individual or corporate, bring considerable business

1. "The Shifting and Effects of the Federal Corporation Income Tax", National Industrial Conference Board, Volume II, p. 110

to corporation lawyers as business men attempt to keep up with tax legislation.

The problem, however, is not simply confined to comparative rates. Other considerations must be noted. First, those profits which are distributed as dividends will be taxed again, leading to double taxation. It is obvious, of course, that any distributed corporate profits have been taxed heavily, first at corporation rates, then at individual rates. An entrepreneur pays income taxes only once at individual rates - if he has elected the proprietorship form of legal entity for his business. The courts look with disfavor upon use of "loans" to disguise distribution of profits in closely-held corporations. Such loans may be reclassified as salary or dividends, if it is clear there is no intent to repay them.

Triple taxation on dividends received by one corporation from another is largely negated by an 85 per cent credit on such income.

It should be brought out that salaries of officers are taxable only once and, therefore, if there are no profits, income tax to the owner of the business would be the same in both cases (corporation or proprietorship). However, the salaries of corporation officers cannot be greatly varied with changes in prosperity to avoid taxes on corporation profits. The incentive is very strong for officers in small closely-held corporations to take the profits in the form of salaries rather than dividends. However, the government insists that salaries of stockholder-officers

and executives be reasonable or the deduction is disallowed; efforts of the tax administration to control the practice of inflating salaries have been moderately successful, though the criterion of "reasonableness" has been,and is, a difficult one to interpret.

Under certain circumstances, double taxation has occasionally been successfully evaded through interest on loans, loans to the owners themselves, rebates, commissions, bonuses, and royalties, but none of these are certain methods of evading the tax; the present tendency of tax courts to rule according to the spirit of the law makes such evasion even more difficult.

If an incorporated business, small as it may be, unreasonable accumulates surplus, a further tax of 27.5 per cent may be imposed.[1] Revenue agents are said to pay particular attention to returns of corporations which have not distributed 70 per cent of earnings in taxable dividends, corporations which invest earnings in securities, those extending large loans to stockholders and officers, closely-held corporations and corporations with large accumulations of quick assets. The intent of this penalty provision is to force distribution of dividends and to prevent accumulation of earnings for the purpose of waiting until individual income tax rates are reduced.

1. 27.5 per cent of the amount of undistributed Section 102 net income not in excess of $100,000, plus 38.5 per cent of the undistributed Section 102 net income in excess of $100,000.

A small business man, dependent in large part on reinvestment of profits for expansion, is penalized by this provision.

A further disadvantage of using the corporate form is that all distributions of profits become fully taxable, though such profit may have been derived from fully or partially tax-exempt income. Individual business income, on the other hand, does not lose any of its characteristics by going through the business.

Another important argument against using the corporate form is the fact that losses by the corporation may not be used by the stockholder to offset other income he may have. A corporate loss (except for certain carry-back and carry-over provisions applicable to the company) is generally a tax waste to the individual stockholder.

An outstanding point to consider is more favorable treatment of individuals in taxation of capital gains and losses. An individual may use his net capital losses to offset ordinary net income up to $1000. However, a net capital loss may only be used to offset net capital gains of other years by a corporation; it can never be used to offset ordinary net income. Carry-over provisions of net capital losses are substantially similar for both forms of enterprise. An individual must pay a tax on only 50 per cent of the recognized long-term capital gain, but a corporation

must take the entire gain into account in computation of its income. However, the alternative method of figuring the tax on the net long-term capital gain has the effect of limiting the tax to not more than 25 per cent, which is actually the maximum effective rate paid by individuals on such gains. It is also significant that net capital losses of a corporation cannot be used to offset net capital gains of the stockholder individually.

The question of payroll taxes is pertinent to this discussion. The payroll tax expense will be increased if inclusion of the owners as employees brings the company into the classification of those having eight or more employees.[1] A second consideration is that, each stockholder-employee, if he earns $3000 ore more per year, adds $150 in payroll expense to the business, calculated on the present maximum of 5 per cent for the total effective Social Security and Unemployment tax rates. Unemployment benefits to the employer himself are hardly worth the tax he pays, as it is seldom the owner who is out of a job.

It might be well to point out that both the courts and the Commissioner look with disfavor upon use of incorporation simply as a means to reduce taxes.[2] The Commission is authorized to distribute gross income, deductions, credits or allowances among any organizations controlled by the same interests, if it determines such

1. Federal Unemployment Excise Tax of .3 per cent
2. "Disregard of Corporate Entity" by J. K. Lasser, Journal of Accounting, Vol. 79, p. 146, Feb. 1945

redistribution is necessary to clearly reflect the taxable income of the taxpayer.

Changing business forms for the single purpose of reducing taxes also may not be successful. "The Supreme Court of the United States has held that while the purpose of avoiding or reducing tax liability will not of itself make a transaction ineffective, a plan (of reorganization) though complying literally with the terms of the statute, will not accomplish the non-recognition of gain where it has no business or corporate purpose".[1]

It is comparatively simple and inexpensive to change from a partnership or proprietorship to a corporate form. Transfer of assets may be accomplished without realizing a taxable gain or loss if immediately after the transfer, the transferor or transferors are in control of the corporation, meaning ownership of possessing at least 80 per cent of the total voting power and at least 80 per cent of the total number of shares of all other classes of stock. When the transfer is by two or more persons, the amount of stock received by each must be substantially in proportion to his interest in the property prior to the exchange. The transfer may be taxable if the property has decreased in value and the partner wishes to deduct the loss on his personal return; or the partners are

1. "Prentice Hall Federal Tax Course" Prentice-Hall, Inc., N. Y. 1946-47, p. 3306

willing to pay a tax in return for the advantage of an increased basis of the assets to the corporation. All they have to do is not qualify for the 80 per cent proportional provision.

In sharp contrast, the immediate tax cost of dissolving a corporation to change to a partnership may make it prohibitive. Any transfer of assets from a corporation to a partnership or proprietorship may result easily in a recognized gain or loss, unless certain precautions are taken. Upon complete liquidation, the fair market value of the property distributed is considered full payment to the stockholders. Unless the distribution upon liquidation is a distribution in kind, the amount of gain would be the difference between the fair market value of the property received and the basis of the stock in the hands of the stockholders. The taxpayer would thus ordinarily pay only a 25 per cent capital gains tax. The new business would then be able to reduce its ordinary income by this revaluation of initial inventories and by greater depreciation. Any gains to the corporation upon dissolution may result in double taxation when such gains are distributed to the stockholders. The Treasury Department will make every effort to find good will in the corporation. The good will may be determined by earnings attributable to tangible assets from net earnings and capitalizing the balance.

A liquidation in kind and distribution of the assets to stockholders has been held legal to avoid income tax to the corporation on gains.[1]

A small but occasionally significant item is the fact that proceeds from life insurance policies which have been transferred from a corporation to a partnership will no longer be fully exempt. The policies would be held to have been transferred for a consideration. The amount taxable would equal the proceeds minus the cash surrender value at date of dissolution and the premiums subsequently paid. Of course, the old policy can be cancelled and a new one issued, if the insured is still insurable. Indeed, insurance proceeds paid to a corporation in itself becomes taxable income when distributed as dividends, though originally tax exempt.

Another point to consider before changing to a partnership once incorporation is elected, is that losses incurred as a partnership cannot be used to obtain a refund of taxes paid by the dissolved corporation on the strength of carry-back provisions. Also, the right of the corporation to carry back any unused excess profits credits is lost, and any carry-overs of capital losses would also be given up.

A particularly attractive form of doing business under certain circumstances is the so-called"family partner-

1. "What's Happening in Taxation and Government Regulation" Prentice-Hall, Inc., Volume 9, No. 12, Sept. 2, 1946

ship". If the state law permits, even minor children may be members of such a partnership, and legally, the partnership between husband and wife can be formalized. The advantage of this type of enterprise is that where the net income is divided among several persons, the surtax brackets are lower. The courts, however, will not uphold such partnerships where the business is a personal service to be rendered obviously by the man; where the husband has made a gift of part of the business to the wife yet continues to exercise the same control as before; or where the partnership is obviously a sham and a tax-dodging device.

In February, 1946, the Supreme Court ruled that the wife must be a bona fide partner - i.e., she must contribute her own capital or services. Mere investing of capital may not mean profits may be shared equally.

Incidentally, a gift tax would have to be paid if the gift were in excess of the $30,000 allowable exemption (or more than the $3,000 annual exclusion). This gift tax, if paid, would not be recoverable if the court rules the partnership is not valid.

In any case, the mere fact a business is called a partnership or proprietorship or association, etc. does

not mean it will be taxed on that basis. If a business resembles a corporation, it will be taxed as such; otherwise, it will be taxed as a partnership.

Some business men have found it advantageous to split up their business into several units. Of course, incorporation is ideal for this purpose; but evasion of high tax brackets through multiple corporations is no longer tolerated. Each unit must have a logical business reason for its existence, without regard to tax savings.

Under the present extremely heavy personal holding company tax laws,[1] it would be unfortunate if an unwary unincorporated proprietor transferred his real estate to a corporation and found his corporation classed as a personal holding company. This may result where at least 80 per cent (70 per cent in certain cases) of its gross income for the taxable year is "personal holding company income".

A contingency which may arise in any partnership is the death of a partner, ending the partnership's tax year on the date of death. Thus, if the fiscal year of the business ends January 31, and the partner dies October 30th, the decedent's last return will have to include more

1. Rate of surtax:-

Undistributed Subchapter A Net Income	Tax (Percent)
Up to $2,000	75
Over $2,000	$1500 plus 85 per cent of the excess over $2000

than one year's income, probably putting the taypayer in a higher surtax bracket. This situation could not arise if the business were incorporated. However, a recent decision holds that mere dissolution does not end the partnership for tax purposes where (1) affairs have to be would up by surviving partner; (2) where business is continued by survivors. For tax purposes, the affairs may be wound up so profits may be thrown into a more propitious year.[1]

Formerly, a partnership reporting on the installment basis was similarly affected by death of a partner, because all unrealized profits of several years' business became suddenly taxable income. This fact made it very dangerous for an unincorporated business to use the installment basis of reporting income.

Business men who contemplate making gifts of interests in the business would do well to consider the advantages of the corporate form. Shares of stock are easily transferred, and there is no possibility that the gift may not be recognized as complete if the taxpayer continues to control the business as before.

A corporation is limited to 5 per cent of its net income as a deduction for contributions, compared to the 15 per cent of adjusted gross income allowed to the individual.

Income taxes of state governments are not

1. "What's Happening in Taxation and Government Regulation" Prentice-Hall, Inc., Volume 9, No. 32, January 20, 1947

generally considered as important or as heavy as those of the Federal government, but there is, in Massachusetts, a very considerable difference in the basis of taxation between a corporation and an individual.

Besides organization and qualification fees of a minimum of $50 or 1/20th of 1 per cent of the authorized capital stock having par value, or one cent per share without par value, every domestic corporation is subject to an annual excise tax.[1] This excise tax is really an income tax based on the sum of the excise tax on "corporate excess" plus the excise tax on net income.

The rate is $5.65 per thousand dollars on the value of the corporate excess. The rate on net income is 2½ per cent plus an additional temporary normal tax (in 1946, 2½ per cent; in 1947 - 1950, 1½ per cent). There is also a 10 per cent additional surtax on account of taxes assessed for the calendar year and a 3 per cent additional surtax for old age assistance. Thus, the actual applicable rates on net income (besides the corporate excess tax) are as follows:

1946: $2\frac{1}{2}\% + 2\frac{1}{2}\% + (5\% \times (10\% + 3\%)) = 5.65\%$

1947: $2\frac{1}{2}\% + 1\frac{1}{2}\% + (4\% \times (10\% + 3\%)) = 4.52\%$

1. Corporation organization expenses are deductible only as a loss upon dissolution.

The state also practises double taxation on dividends distributed by corporations as the recipients of such dividends are taxed in Massachusetts at the high rate of 6.78 per cent.

In addition to the state excise tax return, both domestic and foreign corporations must file an annual certificate of condition for approval by the State Commissioner of Corporations and Taxation. These statements must be filed in considerable detail and are available for public inspection. A small business man must hire at considerable expense a qualified auditor to make an acceptable return.

In contrast to the rather involved corporation excise return, the business income tax of individuals or partnerships is simple to compute and taxed at a low rate. The excess over $2000 is taxed at only 1½ per cent. The state is also liberal in allowing exemptions for spouse and dependents. A business may report on a cash basis even if inventories are carried.

A state tax applicable only to corporations, but comparatively unimportant for our purposes, is the stock transfer tax. The rate is 2 cents on each $100 of face value, or if no par value, 2 cents per share, and the tax is imposed upon the sale, delivery, transfer or agreement to sell any shares or certificates of stock

in any foreign or domestic corporation. The Federal government also imposes a stock transfer stamp tax of 5 cents per share for each $100 of face value, or 5 cents per share if no par value (unless selling price is $20 or more, then 6 cents per share).

It is difficult to recognize the different character a newly-incorporated business assumes. It is under the same control, occupies the same premises, engages in the same business activities, employs the same people, keeps largely the same books - yet, though nothing has changed that is apparent to the naked eye, the mere fact of registration as a corporation has changed profits through different tax expenses.

III THE HEAVY BURDEN OF TAXES OTHER THAN INCOME TAXES

With few exceptions, the only business taxes to which there is an element of progression are Federal income taxes.[1] Therefore, though small business may pay rates on non-income taxes equal to those paid by large organizations, the impact may be much more severe on small business because of lower profitability and less ability to shift the tax.

Although many smaller companies seldom pay income taxes, they are fully liable for other taxes, despite lack of profits. In some cases, these miscellaneous fees and levies far outweigh in importance both Federal and State income taxes.

Payroll taxes fall heavily on small businesses employing large labor forces, such as is typical of the garment industry. The seasonal character of many of these businesses precludes the possibility of ever getting an unemployment tax merit rating. Furthermore, the general requirement that the business must have been in existence for several years before a merit rating can be granted puts new enterprises at a great disadvantage. The only favorable point to small business is elimination of the entrepreneur from the payroll tax base; but if the owner-employer wants to realize some of the advantages of

1. Some states, notably New York, have a slightly progressive income tax.

incorporation, he loses this small advantage. In actual fact, the payroll tax is "regressive" because it constitutes a larger share of business costs of non-profitable enterprises than of profitable enterprises. With every increase in wage rates, the employer is doubly burdened - with higher labor costs and higher taxes.

Social Security taxes are the most pervasive of all taxes in business. Eight out of every ten retailers make payments. Dun and Bradstreet estimated Social Security taxes exceeded all other Federal taxes paid by retailers.[1]

The proportions of total tax costs attributable to the several taxing authorities vary widely among different industrial groups. Retailers and wholesalers are most seriously affected by State and local taxes; manufacturing companies contribute most heavily to Federal tax collectors, especially because of excise and income taxes. Chart IV on the following page brings out this variance.

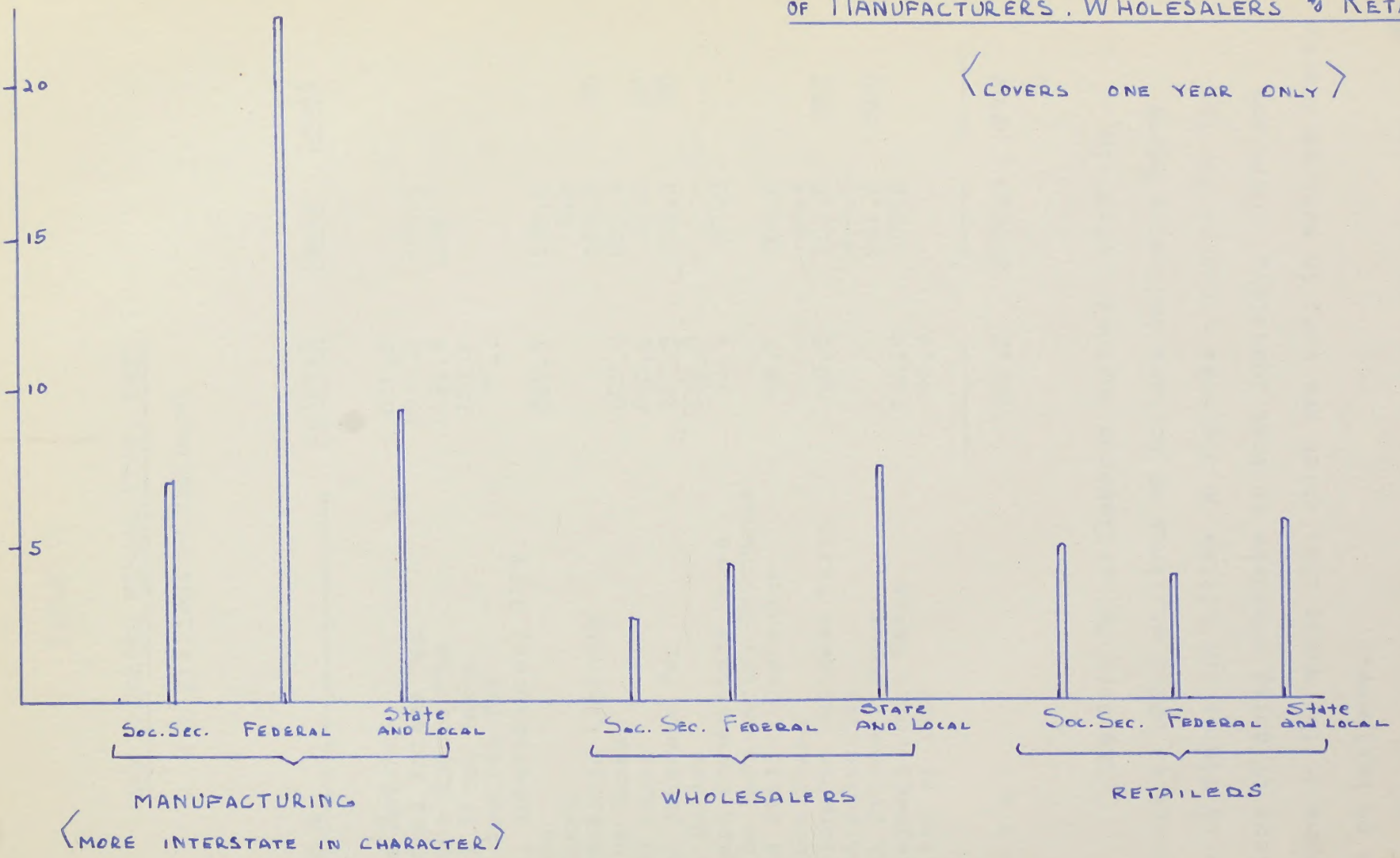
Available tax statistics do not segregate revenues from small business concerns. However, the importance of taxes on business other than income taxes is brought out in Table VI, page 43.

1. Dun and Bradstreet "A Survey on Business Taxes Paid in 1938", p. 11

CHART IV

Estimated 1938 Tax Payments of Manufacturers, Wholesalers and Retailers [1]

(Covers one year only)



1. Dun and Bradstreet "A Survey of Taxes Paid by Business in 1938" P. 11

TABLE VI

TAX RECEIPTS FISCAL YEAR, 1939 [1]

(In Millions of Dollars)

Item	Federal	State	Local
Customs Revenue	318.8		
Individual Income Tax	1028.8	186.9	
Corporate Income Tax	1122.5	142.7	
Capital Stock Taxes	127.2		
Excess Profits Tax	27.1		
Estate, Inheritances, Gift Taxes	360.7	133.0	
Poll Taxes		5.8	
Motor Vehicle Licenses		362.3	30
Gasoline Taxes	207.0	800.9	
Tobacco Taxes	580.2	59.5	20
Alcohol Beverage Tax	587.8	218.5	20
Manuf. Excise	190.0		
Stamp and Documentary Taxes	41.1	27.0	
Taxes on Amusements, Insurance and Utility Companies	62.7	206.8	
Severance Taxes		44.4	
Miscellaneous Business Taxes	40.6	161.6	330
General Sales Tax		442.3	
General Property Taxes		241.2	4300
Unemployment Comp. Taxes	740.4	799.0	
Sugar Act of 1937	65.4		
Total	5500.3	3832.0	4700

The item "miscellaneous business taxes" in the amount of 532.2 millions of dollars indicates heavy levies by States and cities on business concerns for the privilege of doing business in that locality. There are few taxes on the whole list which are not, in part at least, levies on business.

1. Temporary National Economic Committee Monograph No. 3, p. 44

It is estimated that there are 175,000 tax authorities or systems in the United States.[1] A vast amount of overlapping is inevitable and complicates the entire tax picture. Both the Federal government and 29 of the 48 States tax tobacco; alcohol is burdened with taxes imposed by States, cities and the Federal government. A common loaf of bread is said to bear 53 "hidden" taxes, and a bottle of milk was once calculated to represent 76 different taxes.[2]

Property taxes are more of a burden to retailers than Federal income taxes. In Massachusetts, rates range from $16 per thousand to $56 per thousand; but differences in assessment policies may act to compensate for excessively high rates. Southern States attract business by luring big firms with low tax rates or tax exemptions for five to fifteen years, and in addition, may provide lands, plants, equipment and low corporation tax rates.[3] Influential big business may also be more likely to be able to get low assessments. Revenues in Massachusetts in 1938 from property and poll taxes were $233,235,046[4] compared to a total from other sources in the State of only $80,234,994.70.[5]

1. Dun and Bradstreet "A Survey of Business Taxes Paid in 1938"p.6
2. Boston Transcript February 13, 1940
3. Temporary National Economic Committee Monograph No. 17, p. 151
4. "Annual Report of the Commissioner of Corporations and Taxation for the year Ending Nov. 30, 1938", p. 313
5. "Annual Report of the Commissioner of Corporations and Taxation for the year Ending Nov. 30, 1938", p. 306

Besides taxes on real estate and tangible personal property, a host of other State and local levies beset the business man. Using Massachusetts again as an illustration, we have the following list of levies (besides State income, corporation excise taxes, property taxes and payroll taxes):

1. Taxes on Registered Motor Vehicles in lieu of the property tax
2. Tax on Stock Transfers - excise tax on the sale of stock certificates at the rate of 2¢ per $100 par value or 2¢ per share of no par value stock
3. Gasoline Tax - added to the Federal excise tax
4. Betterment Assessments
5. Special assessments (land benefiting from some public improvement within the limits of the street)
6. Motor vehicle registration fees
7. Corporation filing fees
8. License fees for the privilege of doing business, such as:
    a. Sale of non-alcoholic beverages
    b. Manufacture of ice cream mix
    c. Sterilization of feathers
    d. Transient vendors
    e. Stockbrokers
    f. Lunch carts
    g. Dealers in used autbmobiles
    h. Makers of small loans
    i. Gasoline station operators

Federal excise taxes have been declining somewhat in recent years, but are still of serious consequence to all taxpayers:

1. A Gasoline tax of 1½¢ per gallon

2. A tax on issuance and transfer of stocks and bonds (stamp tax of 11¢ on each $100 of the face value of each bond issued; transfer tax on bonds is 5¢ per $100 face value)

3. An automotive vehicle excise tax of 7 per cent of the manufacturer's sales price

4. A levy on communications: 25 per cent of the amount paid on telegraph service

5. A tax on telephone service: 25 per cent of the amount paid on any call over 25 cents; also a tax of 15 per cent on local telephone service

6. A 10 per cent excise tax on electrical, gas and oil appliances

7. A levy on tires and tubes - 5 cents per pound on tires and 9 cents per pound on tubes

8. Transportation services - on personal fares 15 per cent of charge on fares over 35 cents

9. Transportation of property - 3 per cent on the amount paid - by rail, water, air or motor

10. A 10 per cent excise tax on business and store machines

These excise taxes on services and products which business must use in its regular daily routine act like sales taxes on individuals. The small, unprofitable business firm suffers far more than the large company. This type of tax is unjustly discriminatory in favor of big business. These excise taxes are the least likely to be passed on to the consumer directly as they are largely hidden among other costs.

The cost of civilized society is growing. The present proposed Federal budget of over 37 billion dollars is almost six times the cost of government in any previous peace time year. The $7 billions expected from corporation income taxes alone exceeds the total income from all sources in pre-war years. It is axiomatic that as long as heavy military expenditures continue and foreign commitments persist, there is little prospect of significant decreases in the cost of government.

IV THE CLAIM FOR PREFERENTIAL TAX TREATMENT OF SMALL BUSINESS AND PROPOSALS FOR AMENDMENTS

A number of authoritative surveys on the subject have pretty well substantiated the theory that "shoe-string capital" firms die quickly. Based on studies made in individual cities, the Temporary National Economic Committee concluded that only four out of ten grocery stores opening in 1939 would survive three years; only one out of one hundred would be in business for thirty-five years. In manufacturing, the average life span is only eight years.[1] In the wholesale field, a survey made in Poughkeepsie, N. Y., for the period 1844-1927 indicated that less than one-third continued in operation more than ten years.[2] On the average, 51 per cent of all closures were infant closures in 1936-37.[3] In 1942, a good business year, 172,723 business returns out of a total of 479,677 showed no net income at all.[4]

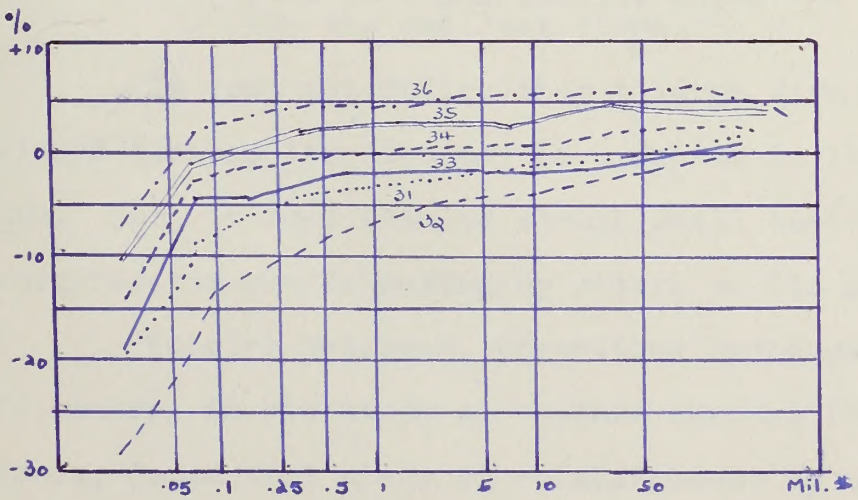
The instability of small business, especially very small business, and lack of profits has been brought out by Dr. William Leonard Crum of Harvard University. In his study, "Corporate Size and Earning Power", he reached the following conclusion: " I believe my findings clearly

1. Temporary National Economic Committee Monograph No. 17, p. 3
2. Temporary National Economic Committee Monograph No. 17, p.45
3. Temporary National Economic Committee Monograph No. 17, p.21
4. U.S.Bureau of Internal Revenue, "Statistics of Income for 1942", p. 8-9

show that on the average, large enterprise - in all or nearly all broad lines of industry, and in different stages of the economic cycle - is more profitable than small enterprise, especially very small enterprise."[1] Dr. Crum continued further to emphasize the importance of this point. "Even in 1936, the year of best return for the entire aggregate, the smallest size class had a negative return, whereas all other classes and the aggregate had positive returns."[2] The following chart illustrates the comparatively stable profitability of large-size corporations.

CHART V

RATE OF RETURN COMPARED WITH SIZE FOR ALL CORPORATE INDUSTRY [3]



Horizontal Scale Logarithmic

1. "Corporate Size and Earning Power", p. 7
2. "Corporate Size and Earning Power", p. 17
3. "Corporate Size and Earning Power", p. 18

Within the low income class itself there is a very large variance in rates of returns in different industries and among different companies within the same industry. The entrepreneur is a risk-taker by profession; he is forced to seek a greater return on his capital than a mere interest return because, generally, that capital is so small.

The Temporary National Economic Committee reached the same general conclusion in regard to profitability as Dr. Crum: " We may conclude that in branches of industry sufficiently large to show wide size distributions (of profit rates), it is highly probable:

(1) There will be a significant positive variation of profit rate with size of firm.
(2) The profit rate for the largest firm will be significantly above the rates for the smallest firms."[1]

It does not follow that a large firm should be penalized because its size may be a factor in its rate of return. But, it does seem as though small business is at a disadvantage in profit-making by reason of its size.

Rudolph Weissman, Securities Exchange Commission staff member, in his study of venture capital for small business, found that class of establishment to be in a very inferior borrowing position, as developed by the following statistics:

1. Temporary National Economic Committee Monograph No. 17, p. 216

TABLE VII

SURVEY OF INTEREST RATES ON COMMERCIAL LOANS OUTSTANDING IN APRIL AND MAY, 1942 AT MEMBER BANKS OF THE FEDERAL RESERVE SYSTEM [1]

Borrowers with Assets of:	Average Annual Rate of Interest, All Banks Per Cent Per Annum
Under $ 50,000	5.5
$ 50,000 - 500,000	4.5
500,000 -5000,000	3.1
Over 5000,000	1.8

It is clear that small borrowers, even those so sound as to be considered good bank risks, pay interest rates three times as high as those paid by large corporations. However, the 5.5 per cent asked by the banks is low, indeed, compared to rates paid by small business to other lending agencies which are not classified as commercial banks. The exhorbitant rates demanded by these non-bank mediums can be explained only by the fact the borrowers can get credit nowhere else.

1. Rudolph Weissman, "Small Business and Venture Capital," p. 35 and 36

TABLE VIII

LOANS OF NON-COMMERCIAL BANK LENDERS [1]

Type of Agency	Percent of Total Loan Balance	Amount	Rate of Charge Per Cent per Annum
Industrial Banking Companies	8	$20,000,000	12 - 30
Regulated Small Loan Companies	5	15,000,000	24 - 32
Personal Loan Depts. of Banks	10	20,000,000	7- 20
Credit Unions	6	6,000,000	10 - 18
Axias	50	9,000,000	12 - 20
Pawnbrokers	5	5,000,000	9 - 60

The comparatively new and very profitable business of lending on assigned accounts receivable depends almost solely on small business for its revenues; the banks are often prone to consider small business as too unsound for conservative banking to risk.

Equity capital is practically impossible to obtain from outside sources. Our financial system is not set up to furnish long-term credit to risk-taking entrepreneurs, thus burdening the little man with a two-fold

1. Rudolph Weissman "Small Business and Venture Capital", p. 36

penalty for being part of small business.

The advantage lies with size in almost every phase of business - quantity purchases, lower unit costs, integrated systems providing a steady source of materials at reasonable prices, national markets, and development of good will and prestige through advertising and branded merchandise.

Economic phenomena affect big business differently. When prices drop, operations can be restricted; production and costs can be cut. The individual entrepreneur in many cases finds his only alternative is to throw himself out of work. It is as inconceivable to think of some of our biggest corporations going completely out of business as it would be to suppose the government should cease its function. Nearly half of the corporate wealth of the United States is in the control of a mere two hundred companies and the largest, American Telephone and Telegraph Company "controls more wealth than is contained within the borders of twenty-one of the States of this country".[1] Adolph A. Berle, Jr., in his book "The Modern Corporation and Private Property" compares the large corporation to the government with reference to the power to coin money. The ability to sell securities at

1. "The Concentration of Economic Power", David Lynch p. 11

will is in effect tantamount to the ability of the government to print money.

The small business man is seriously restricted in his recruitment of new capital. He has no access to the stock exchanges nor to low-interest long-term bond issues; his additional working capital must generally come from reinvestment of earnings and investment in new fixed assets can be made only by paying high interest rates. The small business man cannot easily diversify his risks; all his eggs are in one basket - there is no variety of plants and products to stabilize the business. A year of losses to the small business man may very well mean he must close his doors; big business may have to reorganize after many such losses, but the doors will stay open for business.

The very essence of big business is the freedom from strangling control gained through the publicly-bestowed individuality of incorporation. The public would perhaps be as well, or better, served by extending its benevolence toward small business. It is essentially the survival of our own middle class that is at stake as well as the preservation of a well-balanced economy. Small business as an important factor in this economy cannot exist without access to capital, the enforcement of anti-monopoly laws and encouragement by way of tax relief

or tax incentives. This does not mean the marginal company should be subsidized, but simply that the investment of equity capital in small business, as an important economic objective, be encouraged, for much the same reason that monopolistic profits and excessive corporate integration should be discouraged.

The ease for preferential tax treatment of small entrepreneurs rests partly on the assumption that loss of tax revenue from this source would not have severe governmental fiscal consequences. One economist asserts that "only fourteen per cent of total corporation tax revenues are ordinarily derived from corporations having assets of less than $1,000,000."[1]

Beardsley Ruml, in his book "Tomorrow's Business" maintains that the Federal government is no longer completely dependent on the tax power to pay its obligations because of the elimination of convertibility of currency into gold and control over the management of national banks. Precedent has long been established for subordinating fiscal considerations for favoring political or economic objectives.

The Federal government has for many years been committed by law to a policy of fostering business

1. "The Taxation of Small Business" by Harold R. Bowen, Economist, Irving Trust Co. - Commercial and Financial Chronicle, Volume 164, No. 4508, July 18, 1946

competition and limiting monopolistic business practise. Chain-store taxes were ostensibly designed to continue this policy, but these taxes were not effective because stores were leased to managers who thus became private entrepreneurs, and the number of units was reduced in favor of fewer but larger units. Such artificial penalties on size rarely seem to achieve the desired result.

If business taxes uniformly and ultimately are shifted to the consumer, it would follow that small business could not be at a disadvantage tax-wise. The incidence of business taxes is a complex and controversial subject. At one extreme are those who believe all taxes including income taxes are really part of the cost of production and therefore, like other costs, the consumer must ultimately be forced to absorb them. Some insist income taxes are direct levies on profits and, therefore, the investor absorbs them. Still others believe that taxes are shifted by cutting other costs such as labor and materials causing suppliers and labor to suffer. The number of factors involved accentuate the problem. The incidence of taxation depends on the degree of competition, direction of government regulation of prices and cost factors, the general trend of economic growth, the development of labor productivity, the time which has elapsed

since the introduction of new taxes or the increase or decrease of tax rates, and finally, it depends on the use made of taxes and on the other fiscal policies (e.g. borrowing) pursued at the same time. "It is obvious that no determination of tax incidence can be absolute for any length of time."[1]

The National Industrial Conference Board study on taxation incidence did emphasize that "in general it may be said that competitive conditions are the dominant influence upon the shifting of taxes insofar as they can be shifted at all."[2] If this is true, it follows that small business, the most fiercely competitive type of enterprise, would be more likely to be denied the opportunity to shift the tax through higher prices to the consumer.

Business men, in general, seem to believe that the income tax is not shifted because

(1) many firms report no profits on which to pay taxes
(2) foreign competition prevents higher domestic prices
(3) prices are fixed by convention, listing, etc.
(4) monopolists have already set the price on their products on the level of greatest possible return.

The National Industrial Conference Board drew the

1. Temporary National Economic Committee Monograph No. 3, p. 2
2. National Industrial Conference Board, Volume I, p. 4 "The Shifting and Effects of the Federal Corporation Income Tax"

following general conclusion - from statistical evidence compiled from a list of several thousands of selected corporations: " . . . the theory of tax incidence . . . . is in harmony with the facts of industrial and commercial life. The case is against the possibility and actual accomplishment of the shifting of the tax. What shifting is done is small in total amount and occurs under exceptional conditions , and it does not seem to make much difference whether short or long periods of time be considered."[1] The same principle seemed to apply to manufacturing, trade, construction, extractive financial and banking corporations.

The "exceptional conditions" noted probably referred to competitive conditions. There are probably cases where even a sales tax must be absorbed by the retailer (who is supposed to be really only a collector) because he must lower his own price to keep sales volume at former levels. It has been found that the expenses of smaller firms appear less elastic and more difficult of adjustment as a whole, indicating a lesser ability to cope with increases in taxation by lowering other expenses.[2]

Spokesmen of small business are united in advocating the type of tax relief needed. Their demands

1. National Industrial Conference Board Volume I, p. 152 "The Shifting and Effects of the Federal Corporation Income Tax"
2. Temporary National Economic Committee Monograph No. 17, p. 105

range from simplification of record-keeping and tax laws to allowing small corporations to file income tax returns as partnerships.

Among the most important and most necessary proposals are those furthering reinvestment of earnings. Frederick A. Virkus, Chairman of the Conference of American Small Business Organizations stated that the principal fear of small business is the fear of inability to retain sufficient earnings to stay in business.[1] They ask for exemption from taxation for a percentage of "retained earnings" or exemption from taxation of "retained earnings" for a certain length of time to foster plant expansion. The government, however, discourages creation of such reserves unless a definite program of expansion is contemplated. Section 102 provides a penalty for retention of profits in the business as such a practice may well be a device in a closed corporation to avoid double taxation to the owners.

Business men are agreed that small business needs more liberal depreciation allowances on fixed assets in the early years of the life of such assets. New businesses, especially, find it difficult to pay income taxes greatly magnified because depreciation expense as defined by the government is low. It may well be the

1. Frederick A. Virkus Statement, October 16, 1944, Congressional Committee

new business will fail long before the depreciation is used up.

Operating loss carry-overs and carry-backs may be of great aid to small business. However, business depressions often last much longer than two years. Five-year carry-overs would probably prove a valued privilege to small business during long periods of business inactivity such as was experienced during the period 1931-1935.

The plea of small business for the right to incorporate at a reasonable fee has already been discussed. This important question might be settled by Federal incorporation, but such a solution would be subject to much opposition by the States and big business itself. The suggestion that small business should have the right to file income tax returns either as a partnership or a corporation has merit insofar as it would give business men more tax security if they decide to incorporate.

Reduction of tax rates would certainly stimulate investment and encourage business again toward greater profits.

At this writing, proposals for income tax reductions are being debated in Congressional committees. Representative Knutson's request for a flat 20 per cent

reduction on all individual incomes up to and slightly in excess of $300,000 is obviously partial to those of his constituents with high incomes. Under the proposed rates, the following savings would be effected, assuming the taxpayer is a married man with no dependents.[1]

Net Income Before Personal Exemptions	Savings affected By 20% tax Reduction
$ 3,000	$ 76.00
10,000	437.00
25,000	1,816.40
100,000	12,625.50
300,000	46,912.90

Tax credits for equity investment in small business would certainly encourage its growth, but this type of proposal would have practically no chance at all of being passed as small business alone would be favored.

Elimination of double taxation has many proponents, both among theorists and tax experts. While the principal result of such legislation would be relief to investors in big business, small business would be benefited in no small degree and entrepreneurs would probably rush to incorporate. It would be a long step toward elimination of inequality of taxation between corporations and

1. "What's Happening in Taxation and Government Regulation" Prentice-Hall, Inc., Volume 9, No. 31, Jan. 13, 1947

partnerships.

Increased employment should be a government objective in its tax policies. The principle that those businesses creating more opportunities for employment should obtain tax credits is an interesting one; but small business would as a whole probably benefit to a lesser degree than large corporations. The rate of growth of large firms is several times that of small companies.

The importance of a proper tax program for a solvent America cannot be overemphasized. Because capital is the fountainhead of jobs in our capitalistic system those who supply venture capital are the creators of employment opportunities. Unincorporated business and small corporations are an important field for such investments. According to the Committee on Postwar Tax Policy, the net income of sole proprietorships and partnerships alone has averaged more than half as much as corporate net income since 1924.[1] While it is true that taxation in itself cannot create the spirit of enterprise, it can limit or destroy it when badly devised and imposed at excessive rates. Any tax harmful to business is often injurious to the entire nation. Vigorous private enterprise is essential to the American way of life as we know it; a sound tax and fiscal system is essential to an

1. "A Tax Program for a Solvent America", p. 10

active and healthy economy.

A favorite complaint among small business men is the present necessity of employing extra bookkeeping or accounting help because of tax laws and government regulations. Accounting and legal talent must be hired at considerable expense to make out income tax returns, refund applications and information returns. It is difficult to see how in a complex society this situation can be avoided, however. The apparently growing trend to make business the deputy collector of taxes for both Federal and State governments throws an additional burden on the entrepreneur. Sales taxes, excise taxes, and income taxes are but a few of the numerous government levies collected through business.

The economic contributions of small business are of great moment. Service to the consumer is accomplished in many ways, chiefly by constant competition and personal relationships. Contributions to big business are not inconsiderable and, of course, proved invaluable during the war on sub-contract work. Competition with big business, while hardly even existing in many industries, does make some impression in consumer goods industries. Standards of personal initiative and aggressiveness are set

by the independent entrepreneur. The amount of gainful employment provided by small business has already been stressed.

The fact that the welfare of small business vitally concerns the public cannot be disputed. When only 14 per cent of the thousands of independent grocery stores can make enough profits to pay any taxes at all, it seems that much of small business is sub-marginal. Of course, it cannot be denied that thousands of storekeepers, like farmers, draw in effect a non-taxable living from their businesses. Also, many business men who keep accounts on a cash basis possibly do not report all cash income for tax purposes. Yet, the high mortality rates previously cited indicate that the plight of small business is serious.

V ACTUAL TAX CONCESSIONS AND GOVERNMENT AID

Despite considerable publicity to the contrary, the facts are that government aid to small business - financial, commercial or economic - has been neither of great weight nor consequence.

The progressive element in corporation income taxation was adopted only after 1936. Prior to that time, the tax had always been proportional (not in accordance with ability to pay), ranging from 1 per cent in 1913 to 13 3/4 per cent in 1932-35. From 1918-1931, a small element of progression did exist due to a credit of $2000-$3000 granted to companies with net incomes below $25,000, thus making a slightly lower effective tax rate. This was repealed in 1932 at the very nadir of the depression, vaulting the effective tax. The Revenue Act of 1941 increased the degree of progression considerably, making effective rates 21 per cent to 31 per cent with the maximum rate pertaining to net income over $25,000. From 1932-35, small corporations were subject to the same statutory rates as large corporations.

The 1940 excess profits tax law was also ostensibly a concession to smaller size. The law taxed profits in excess of (a) 8 per cent of invested capital plus $3,000, plus certain carry-over adjustments or

(b) 95 per cent of the average profits for the years 1936-39. The tax rates on the amounts remaining after the foregoing credits were applied, were as follows:

Adjusted Excess Profits	Rate (per cent)
The first $ 20,000 at	25
30,000 at	30
50,000 at	35
150,000 at	40
250,000 at	45
500,000 at	50

This results in a penalty on size because a small concern, though earning a large return will stay in the first bracket. On the other hand, a large firm, though earning only a 9 per cent return, might find itself in the highest bracket.

The Revenue Act of 1941 increased the rates in each bracket by 10 per cent and the invested capital credit was changed from a flat 8 per cent of invested capital to 8 per cent of the first $5,000,000 and 7 per cent of the balance, again a penalty on size to a small degree.

Another small penalty on size has been the rather recent (since 1932) tax laws concerning filing consolidated returns, designed to prevent large firms from using losses of one company to offset profits from another.

The penalty tax is very small, however, and the tendency has been to break large systems down into as many units as possible to avoid the progressively higher income taxes. For 1942, the number of consolidated returns filed was only 1944, .2 per cent of all corporation returns (though these few returns contained 10.2 per cent of the net income of all corporation returns[1]). This is in sharp contrast to the fact that in the period 1928-1931 at least half of all Federal taxes upon corporate income were reported on consolidated returns.[2]

Present corporation taxes are graduated from 21 per cent to 38 per cent, but it takes a net income of only $50,000 to pay the same rate of tax as paid by companies earning millions of dollars. Actually, therefore, the tax is more proportional than progressive.

Companies employing less than eight people are favored by reduced Federal payroll taxes. Also, proprietors or partners need pay no payroll taxes on their own drawings from the business.

Under the revisions of the undistributed profits tax by the 1938 Revenue Act, small business (corporations with net income under $25,000) was practically exempted; but emasculation of the rate provision largely nullified

1. U. S. Bureau of Internal Revenue "Statistics of Income for 1942", p. 5
2. "Modern Corporation Finance", by William H. Husband, p. 2

the tax anyway and it was repealed in 1939.

The tax system is not only a source of public revenue, but a technique of government. Tax measures strike at the very heart of economic power - the payment of money. The Temporary National Economic Committee lists the following as among the "non-fiscal desiderata" of a good tax system within a democratic framework: [1]

1. Full employment of men and capital
2. Preservation of opportunity by encouraging small business
3. Curbing of monopoly
4. Support of people in need by low taxes in lower incomes

It does not seem as though the Federal government has built its tax framework to encourage small business. It is not advisable that small business should be aided by unduly penalizing big business; but relief from onerous taxes where possible must be considered.

It would be interesting at this point to examine the government's attitude toward small business in general.

In 1934, the Reconstruction Finance Corporation was authorized to make loans "backed by acceptable security". Those loans under $5000 granted as of February 29, 1940, amounted to but 1.7 per cent of the total amount loaned, $294,202,359.35. Whatever the reason, RFC's aid to small

1. Temporary National Economic Committee Monograph No. 9, p. 115

business has been slight. The routine involved was too cumbersome for inexpert small business men and the data required was either not available or too costly to obtain.

Another well-meant but similarly ineffective piece of legislation was the Glass-Steagall Banking Act of 1932 which empowered Federal Reserve Banks to make loans to business directly. Conservative bankers were never very enthusiastic about lending money to small business and, furthermore, did not want to encroach upon a field set aside for RFC. The result was very few loans to small business men.

The Sherman Anti-Trust Act and the Clayton Act which followed, have proved both ineffective and expensive as measures to curb abuse of monopoly powers. They are very useful in making work projects for lawyers, but have never achieved their avowed purpose. It is interesting to note in this connection, for example, that the drug trade forced adoption of "fair-trade" laws to legalize fixed retail price maintenance which had been previously held to be illegal under the monopoly laws and by the restraint of trade doctrine.

The Temporary National Economic Committee researches completely avoided the subject of pressure-group politics

and the exploitation of the State by special interest groups. The study consumed 17,000 pages of testimony and was pursued for almost three years, yet in spite of its findings, no one was prosecuted and the remedial measures it suggested never materialized. As a matter of fact, the entire project was powerfully resisted as another New Deal instrumentality to torment and harass business.

In addition to the Congressional committees on small business, several government agencies have been created to help independent entrepreneurs. A Small Business Section has been established in the Department of Justice; the Federal Trade Commission also has a Small Business Bureau; in addition, there is a Small Business Dividion in the Department of Commerce, and a Smaller War Plants Corporation in the War Production Board. In connection with the War Production Board, it is worth mentioning the fact that the great bulk of the plants built by the government were built for and operated by big business, not small firms. Contracts were withheld from small business for several reasons. The important positions in procurement were held by men, drawn from big business, and they, naturally, favored that type of concern. Also, it was easier to deal with a few concerns than with a large number. Small entrepreneurs could not get contracts

without having the necessary machinery and equipment, and they could not get the machinery without the contract to get the money to buy the machinery with.

Reverting again to the subject of taxation, if the Federal government were really intent upon helping small business, it would be a comparatively simple matter to find many precedents for regulation through taxation. For instance, dangerous and poisonous yellow sulphurous matches have been taxed out of existence. Indeed, too often the power to tax has been used openly for the benefit of certain groups and clearly without reference to the public welfare. Levies on the sale or manufacture of margarine are imposed by the Federal government and twenty-four states, and, of course, such taxes are most effective when they are not collected. Interstate trade barriers, milk inspection laws designed to exclude distant producers, laws to drive peddlers off the streets for the benefit of retailers, laws against trucks to help railroads,are common and accepted government concessions to private interests without regard for the public good. So many complicated and powerful influences have arisen that "belief in free and unrestricted competition has become part of the folklore of the twentieth century, a heritage of the nineteenth."[1]

Present income tax laws are partial to people whose incomes are earned over long periods of working time,

1. "The Concentration of Economic Power", by David Lynch p. 109

but which are received in a lump sum. Thus lawyers, architects and authors are benefited if payment is received for work that required at least 36 months duration and such payment is at least 80 per cent of the total received in the taxable year. The taxpayer can apply his income on a pro-rata basis over those years, if his tax for the taxable year is larger than it would be if spread out over the entire period.

This ruling is denied to business men who may similarly have spent several non-profitable years building up a new business, but who must take income in the year it is received or earned. He has no privilege of spreading profits over past years under the 36-months rule, though in principle, his income was the result of exactly the same type of efforts as the author's or lawyer's.

Tax concessions to cooperatives often create conditions of unfair competition. They own millions of dollars worth of property yet are almost always exempt from taxation due to political influence.

The farm bloc long ago forced the Federal tax system to favor agricultural entrepreneurs; the farmer's entire living, and subsistence is virtually tax-free, and in addition, the farmer is heavily subsidized by the government. Mutual insurance companies are by law exempt from all Federal corporate income taxation. Life insurance

companies are also specifically favored. Operators of gas and oil wells are given the valuable privilege of substantial depletion deductions (27.5 per cent), far beyond the general depletion rules. Railroads, banks, and hundreds of other parts of our functional economy have at one time or another been bailed out by the Federal Government.

Some tax experts even maintain that the excess profits tax was just a penalty tax on those corporations guessing badly in declaring capital stock for tax purposes. The tax did not discriminate against monopoly profits and did work against small business with fluctuating profits.

Many small companies started the war with little capital and poor earnings records, but mushroomed with very high incomes during the war. But since they could claim almost no excess profits tax credit, a major portion of their earnings has been subject to a 95 per cent excess profits tax with an over-all income and excess profits tax ceiling of 80 per cent, meaning these companies could grow only to the extent of 20 per cent of their profits. The entire theory of the excess profits tax may be questioned in that it nullified the function of profits.

If it is true that small business is the "seed bed of new ideas and the yeast of a dynamic industrialism" and its maintenance essential to wide opportunities of consumer choice - all prerequisites of a free economy - we must not let its struggle for survival

go unaided simply because its pressure on a lobby-ridden government is weak and ineffectual. One definition of small business is "the type of business that is too weak to have a lobby in Washington". Perhaps the fundamental truth is that popular government has evolved into government by pressure groups and legislation tends to serve special interests rather than the common good.

Without doubt, very often legislation has not achieved its desired end because, though well-meant, the legislation itself was faulty in construction. The patent laws, originally formulated to protect poor inventors, have become a most effective instrument of big business. By pooling of patents, use of inventors as agents whose inventions become the property of the companies employing them, and by hiring the legal brains necessary today to interpret the complicated patent laws, important developments have become largely the product of a relatively few companies.

It cannot be denied that government assistance to small business has been offered to some extent. But it seems that however well-intended such offers have been, the effects on small business have not been notable. It is difficult to see anything but failure so far in the Federal program to aid small business.

VI EFFECT OF TAXATION ON MANAGEMENT

Under our complicated tax system, the non-specialized, small business type of organization is much less capable of coping with the tax laws than large corporations with alert legal departments. Taxes are a cost and, like other costs, should be treated in a manner to minimize them as much as possible. Policy decisions which will have an ultimate effect on the company's tax bill must be faced in the every day course of business.

The last few years have witnessed changes in tax theory and practice of great importance to management:

> "It is often said, erroneously, that taxes are imposed on one year's operations and restricted only to the income of that year. Recent tax law has done much to destroy the theory of annual income accounting. Actually, you often compute your taxes on your income over a long cycle of years. For example, our carry-backs and carry-forwards of losses in operations are now allowed as a deduction over a cycle of five years. A continuance of the profits taxes with its carry-over of unused credits might possibly have spread this cycle to a nine-year period"[1].

There are many other examples of privileges given to certain groups to spread income over long periods. Special relief is provided for taxpayers who work for long periods of time without pay and then receive all, or a

1. "Your Tax Man Should Govern Your 1946 Business Policies", by J. K. Lasser, Advertising and Selling, July, 1946

large part of their compensation upon completion of the undertaking. This provision is designed primarily to benefit lawyers, inventors, artists, etc. Special relief is also provided for individuals who receive back pay attributable to prior years in an amount in excess of 15 per cent of gross income (including back pay) for the taxable year. Another sign of the trend is the law pertaining to the sale of gas or oil property where the value of the property was caused by exploration or discovery of the seller; in this case, the surtax may not be more than 30 per cent of the sale price of the property.

The so-called "tax benefit rule" is also indicative of the trend. This rule applies to all recoveries of losses, expenditures, and accruals originally deducted, and especially, it applies to bad debts, prior taxes, and tax delinquencies. Under this rule, the taxpayer is not considered to have income from a recovery (of a bad debt, for instance), unless the deduction, when taken, gave the taxpayer a tax benefit. Instances where this rule would provide substantial tax savings are common:

1. Rebates in one year on purchases in prior years.
2. Losses on stock in prior years reduced by subsequent recoveries
3. Losses on worthless stock recovered through action against a director, officer, etc.
4. Accrued interest cancelled on settlement of an obligation

The excess profit tax has been a vital factor in management decisions. The first such tax since 1918 was levied in 1933. These taxes were increased periodically through the next decade and drove many corporations back to proprietorship or partnership form. The big problem for management was to guess what earnings would be, so as to judge at which value it was most economical to declare its capital stock.

However, tax refunds resulting from excess profits credits created an enormous stimulus to maintenance of the selling effort in the difficult reconversion period of 1946, and aided materially in maintenance of advertising schedules. The law said, in effect, "If you lose money or if you do not make as much as your old excess profits credit, we will give you a refund of your excess profits taxes - the taxes collected at 95 per cent of your income during the war years."

Management must be alert to all the implications of pertinent tax laws. Thus the amount of stock issued and outstanding determines the size of State franchise taxes; there is an incentive to keep the amount of such stock small, if possible.

Changes in tax laws may result in serious organizational problems if the taxes cannot be shifted:

1. Companies may combine, merge, or make cooperative arrangements to control prices
2. Production may be curtailed to arrive at a new point of greatest profits
3. Labor-saving devices may be induced by added payroll taxes
4. Methods of obtaining capital may be changed to take advantage of interest deductions on tax returns
5. Movement to locales of lower taxes may be decided upon
6. Dissolution may be decided upon in favor of going into another business
7. Other alternatives: improve efficiency, move nearer to markets, reduce wages, reduce overhead, buy cheaper materials

Since 1918, practically all interest has been deductible except that incurred for the purpose of carrying tax-exempt securities. This has encouraged the use of creditor capital instead of equity capital, and as a result economic stabilization of enterprise has been decreased, with greater danger of forced liquidation and receivership.

Sec. 102 poses a peculiar problem for management. It asks for payment of dividends before profits are known. If the business does not pay at least 70 per cent of its profits as dividends, it may be subject to a penalty tax up to 38½ per cent. Of course, the law does not say dividends paid must equal 70 per cent of earnings, but unless that amount is paid, the company may be investigated for unreasonable accumulation of surplus.

Tax laws have far-reaching effects on accounting and bookkeeping methods. For instance, for tax purposes

inventories must be valued in accordance with approved practices. The method selected by management may well have serious effects on profits; the last-in, first-out method will produce ostensibly lower profits in periods of rising prices, and the effect will be to inflate profits in periods of falling prices.

Small businesses are often given the choice of reporting on a cash or accrual basis. The cash basis is generally selected as the simpliest, but if inventories are a major income-producing factor, the accrual basis is prescribed by law.

Management is often faced with exchange transactions where, if it is unwary, a taxable gain may be recognized. If income-producing property is exchanged for property of like kind, the exchange is non-taxable. For tax purposes, property acquired by such exchanges assumes a basis, not by cost, but dependent on the value of the traded article. Consequently, depreciation is affected because of the different basis.

Depreciation rates and methods must be in accordance with approved rates of the Bureau of Internal Revenue. Also, classification of expenses and capital expenditures is made in the light of government approved practice.

The significance of capital gains provisions must

be fully appreciated. Business is favored because business real estate and depreciable property held more than six months are regarded as capital assets. Knowledge of this provision may conceivably cause great tax savings in certain situations.

Deductible expenses are deductible only because the law says they are so denoted. Due to high tax rates, many businesses have adopted "spendthrift" policies in an effort to build up good will rather than pay profits to the government. Tremendous sums spent on research, advertising and sales expense (entertaining) were really appropriated to reduce taxes on profits.

Industries with depletion problems must be aware of the most propitious method of depletion deduction allowed by the government. Vast sums are saved annually by companies using the percentage method instead of the general rule.

Choice of the fiscal year may postpone paying a tax for a better period. The only limitation is that the year be only 12 months long. Likewise, use of the installment system of reporting income will defer profits until they are realized - a great boon to retailers.

Charge-off of bad debts cannot be postponed to years of greatest profits. These losses must be taken when they are sustained, and the burden of proof as to the time the debts became bad rests with the taxpayer.

This list might be supplemented by dozens of other methods calculated to legitimately lower the cost of doing

business. Unfortunately small business often cannot afford expert advice on tax matters. Usually, it is a case of doing something and finding out when it is too late it was the wrong thing to do. There are no rules or formulae. No two businesses pay exactly the same assortment of taxes in the same relative amounts.

The general belief that taxes are a necessary evil, to be resisted as far as possible, has turned the study of taxation into a complicated metaphysics. Order, rhyme and reason are lacking in many cases and what is left unwritten in the law often has greater repercussions than the letter of the law. There is a considerable overlapping of taxing bodies and resulting conflicts and duplication.

Organizations and individuals who have much to lose find it profitable to spend considerable efforts and money to find new ways of escaping taxes. Indeed, the idea has been growing that "taxation without litigation is tyranny". Though private industry is regarded as above reproach, the government is deemed chronically malevolent and wasteful, and, therefore, a man who pays taxes unnecessarily is a fool.

The sad truth is and has been that the administration cannot adequately enforce the tax laws. In 1946, only 2000 fraud investigations were undertaken out of some

41,000 suspected cases. The great increase in the national income since 1939 has increased the volume of returns many times, but the number of returns investigated has remained relatively stable. Thurman Arnold appraised the situation quite succinctly: "The collection of income tax from powerful individuals and organizations became a combat rather than a business transaction, in which forty-five thousand registered lawyers and tax accountants were pitted against some 2800 persons employed by the government."[1]

In business circles, at least, tax avoidance is not regarded as immoral or unethical. If, by properly pursuing his business activities the taxpayer can reduce his tax liability, he has accomplished a valid business purpose. He has minimized a cost that affects profits just as much as other costs. It is agreed that proper tax guidance is one of the most important considerations in making money today. Neglect or ignorance in tax matters is as serious to the business man as carelessness in production.

It is the job of management to be well aware of the distinctions between avoidance of tax liability and evasion. Evasion carries civil and criminal penalties; avoidance, which is considered a fair game today in the highest circles, carries no penalties except payment of the tax and a small interest charge. Recent court rulings

1. Thurman Arnold "The Folklore of Capitalism", p. 322

have tended toward the view that the spirit of the law must be considered as well as the letter of the law, and intent to avoid payment of taxes through legal loopholes may not be so successful in the future.

Most tax-dodging devices attempt to achieve their affect through one or more of the following objectives:

1. Convert taxable values into their lowest taxable form as
    a. Transmuting income into long-term capital gains
    b. Splitting income among several units to get lower surtax rates
2. Minimize the taxable amount by
    a. Maximizing deductions
    b. Deferring income to a year of lower tax rates

Generally, most intensive practice of tax avoidance is by those who can best afford to pay those taxes. The withholding laws take care of wage-earners, on the bottom of the scale. It is interesting to review methods by which successful wealthy people and corporations have circumvented the spirit of the law:

1. Big corporations have for over twenty years been using the device of tax-exempt reorganizations to avoid taxes. This non-recognition of gain or loss in reorganization has been phrased a fantastic and complicated metaphysics. The legislature, courts, and administration have been trying to stop this loophole since 1924 without much success.
2. Personal and foreign holding companies were used for several years to take advantage of low corporation income tax rates.

3. It is still legal for wealthy people to incorporate their hobbies, such as racing stables and estates (farms) and have them operate at losses year after year, deductible from other income. Only limitation-losses cannot exceed $50,000 a year for five years.

4. The Hollywood or "collapsible" corporation is a still legal device, whereby income is turned into long-term, low-taxed capital gains. The principals of each production receive stock which is disposed of when the production is finished and the corporation liquidated.

5. Income-bearing trusts for dependents are still a popular - and legitimate - method of splitting income.

In the case of the community-property laws (of nine Western States) the government itself sponsors tax avoidance through splitting of income between husband and wife.

Apparently, judicial and administrative processes are too slow and cumbersome to effectively throttle tax-dodging. The most unfortunate part of it is the people who can least afford to pay the tax are those least likely to be able to avoid it.

Small businesses are often in the same position as individuals in low-income brackets. They have little opportunity to reduce taxes, yet may find it difficult to pay the legally-designated amounts.

VII CONCLUSION

The theme of this paper throughout has been the growing concentration of economic power and the importance of small business as a force to combat this trend. "If democracy is to survive it must be vigilant, strong, freeful, and constantly able to defend itself against concentrated economic power. For when the rulers of industrial empires control the state, the inevitable result is fascism and destruction of liberty!" [1]

The acid test of business is not the profit and loss statement, but the social audit. Private enterprise justifies itself only insofar as it provides us with the maximum standards of living.

The small business man has been driven out of entire industries; he is today concentrated in retail and wholesale trade, service and some consumer goods branches of the manufacturing industry. One of his troubles is that today he loses all if his gamble fails and can gain only a fraction if he wins.

Government Aid and subsidy programs, which have at times greatly assisted such groups as farmers, banks and railroads, has not been available to small business. Of all the great blocs of income-producing

1. Temporary National Economic Committee Monograph No. 7 "Measurement of the Social Performance of Business" p. 117

factors in our economy, small business is undoubtedly the weakest. It is like comparing the power of white-collar workers to the power of labor. There just is no comparison between the influence on legislation of big business and small business, though the latter category probably embraces many more people.

The study of the tax problems of small business has been generally overlooked. Most of the literature is concerned with corporation taxation. The difficulties of accurately determining the extent of taxation of small business itself are staggering. Statistics are not collected with this end in view. The Temporary National Economic Committee investigation did not study this problem, despite its vast resources. Was it neglect or evasion of the problem? The evidence seems to indicate this study neglected few other phases of the concentration of economic power.

Not only does the American tax system fall too heavily on low-income groups, it penalizes new enterprise. It is analagous to the old adage that the pennies of the poor are extracted with the minimum of difficulty.

There is no simple solution to alleviate the difficulties of small business. The roots of the problems involved lie deep in the heart of our political and economic structure. Tax reforms will not be a panacea

for all the ills of small business organizations. However, a lesser tax burden will ultimately encourage investment of equity capital in concerns of medium and lesser size. Reluctance to embark on new ventures would be somewhat overcome by more favorable tax legislation, and the American traditions of initiative and aggressiveness would be strengthened.

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